C. UPDATE ON UNRELATED BUSINESS TAXABLE INCOME

1. Introduction

The CPE Texts for both 1987 and 1988 contained articles that set forth the many developments occurring in the area of unrelated business taxable income. Two years ago, Supreme Court decisions highlighted the discussion. Last year, five days of Congressional hearings and a number of interesting lower court decisions were described in detail. This year's topic is intended to provide another update on unrelated business taxable income.

Although there were relatively few court cases in this area during 1988, the few decisions reported focus on two perennially important issues: advertising income and social clubs. These cases will be fully detailed. Also, reference will be made to additional Congressional hearings and other developments in Congress. Last year's CPE text beginning at p. 97 identified certain new issues arising in the area of unrelated business taxable income, including the issue of credit cards. For a complete discussion of the credit card issue, see Topic D, Royalties, beginning at p. 31.

2. Congressional Action

A. Background

In September of 1986, the Chairman of the House Ways and Means Committee, Dan Rostenkowski, requested the Chairman of the Oversight Subcommittee, J. J. Pickle, to conduct a comprehensive review of the federal tax treatment of commercial and other income-producing activities of exempt organizations. The Oversight Subcommittee was charged with the responsibility of examining the policy considerations underlying the appropriate tax treatment of income-producing activities of exempt organizations, the impact of present law rules on both tax-exempt organizations and for-profit businesses, as well as the Service's application of, and taxpayer compliance with, the law.

Beginning on June 22, 1987, over a period of five days the Oversight Subcommittee held hearings on unrelated business taxable income. The Subcommittee heard approximately 100 witnesses representing the nonprofit sector, the business community, and the academic world. In summary, those speaking on behalf of exempt organizations were of the opinion that current law is

adequate, that additional reporting requirements might be acceptable, that Congress should proceed cautiously in considering legislative changes, and that complaints of competition are merely anecdotal. These witnesses testified that additional factual data are required. Business representatives attempted to convince the Subcommittee that a significant problem exists requiring immediate legislative action, that current law is not working, and that there is inadequate enforcement.

Following the 1987 hearings, the Oversight Subcommittee proceeded to consider the information and testimony presented. Over a period of approximately nine months, the entire area of unrelated business taxable income was extensively reviewed and analyzed by the Subcommittee.

B. Discussion Options

On March 31, 1988, Chairman Pickle announced the release of the Subcommittee's discussion options on unrelated business taxable income.

The full text of the discussion options as they appear in the Subcommittee on Oversight's Press Release #16 is set forth below:

I. "Substantially Related" Test:

Repeal "substantially related" test and replace it with a "directly related" test.

Determine whether each income-producing activity standing alone is tax-exempt.

Retain "substantially related" test; however, impose UBIT on specified activities (as listed in A-L below) whose nature and scope are inherently commercial, rather than charitable.

A. Apply UBIT to gift shop/bookstore income (with exceptions for (1) on-premise sales of low-cost mementos, (2) on-premise sales of an educational nature which relate to the organization visited, (3) in the case of a hospital, articles generally used by or for inpatients, (4) in the case of a university, articles in furtherance of educational programs, or low-cost items (dollar cap), and computer sales not in excess of

one sale per student/faculty per year. In addition, apply UBIT to income from all catalog and mail/phone order or other "off-premise" sales (with exception for de minimis sales, in relation to amount of "on-premise sales").

B. Apply UBIT to all sales or rental income of medical equipment and devices (including hearing aids, portable x-ray units, oxygen tanks), laboratory testing, and pharmaceutical drugs and goods (with exceptions for (1) inpatients, continuous-care outpatients, or emergency treatment outpatients or (2) items not available in an immediate geographic area).

C. Apply UBIT to income from certain health, fitness, exercise and similar activities unless program is available to a reasonable cross-section of the general public such as by scholarship or fees based on community affordability.

D. Apply UBIT to travel and tour services (with exception for services provided by colleges/universities to students/faculty as part of a degree program curriculum, and de minimis sales to nonstudents/faculty).

E. Apply UBIT to adjunct food sales (with exception for on-premise services and/or sales provided primarily for students, faculty, patients, employees, members, or organization visitors).

F. Apply UBIT to income from certain veterinary services such as grooming, boarding, and elective surgery (with exceptions for spaying and neutering, measures to protect the public health, and measures recommended by a veterinarian for the health of the animal).

G. Apply UBIT to hotel facility income which is patronized by the public (with exception for facilities

operated, but only to the extent necessary, in furtherance of the organization's exempt purposes). In addition, apply UBIT to certain sales of condominiums and time-sharing units.

H. Apply UBIT to routine testing income (with exceptions for Federal or State mandated activity, pre-surgical medical testing, and laboratory testing which is part of a student educational training program).

I. Apply UBIT to income from affinity credit card/catalog endorsements.

J. Apply UBIT to advertising income and allow deductions from UBIT only for direct advertising costs.

K. Apply UBIT to theme/amusement parks.

L. Apply UBIT to additional specified activities determined to be inherently commercial.

II. Convenience Exception:

Repeal "convenience" exception (income from activities carried on primarily for the convenience of a Section 501(c)(3) organization's members, students, patients, officers, or employees). Income from activities that are substantially related to the organization's exempt purpose would remain tax free, subject to the specific rules listed in Section I., above.

III. "Regularly Carried On" Test:

Repeal "regularly carried on" test. Income from an activity that is not a trade or business would remain tax-free.

IV. Tax Treatment of Royalty Income:

Apply UBIT to royalties measured by net or taxable income derived from the property; or royalties received by an organization for

use of property if such organization, or closely related organization, either: (1) created such property, or (2) performed substantial services or incurred substantial costs with respect to the development or marketing of such property. Retain present law for certain non-working property interests, and exception for products that are part of the organization's exempt function.

V. Deduction from Taxable UBIT:

Increase $ 1,000 UBIT deduction for certain Section 501(c) organizations to $ 5,000 or $ 10,000, with phase-out beyond $ 50,000 income level. Limit the increased deduction to activities directly carried on by the exempt organization.

VI. Unrelated Debt-Financed Income:

Limit the current law UBIT exception for unrelated debt-financed property to only those pension funds, educational institutions and title holding companies that make at least a 20 percent equity investment of their interest in the property. Retain character of debt-financed income received from all pass-through entities.

VII. Subsidiaries and Joint Ventures:

Modify the definition of "control" in the case of exempt organizations having taxable subsidiaries. Define "control" as ownership directly, indirectly, or by attribution of at least 50 percent of stock, by vote or value (rather than 80 percent of combined voting stock, under present law).

Extend "control" rules where exempt organizations in the aggregate own more than 50 percent of the subsidiary's stock.

Provide that a controlled taxable subsidiary's income can be no less than its UBIT would have been if the income-producing activity had been carried on directly by the exempt parent organization. Aggregate income and activities of controlled subsidiaries for purposes of determining if primary purpose of parent is a tax-exempt purpose.

VIII. Allocation Rules:

With respect to facilities used for exempt purposes as well as unrelated business purposes, allow a deduction against UBIT for a proportionate share of the direct operating cost of the facility (e.g., maintenance, insurance, and utilities), but not allow a deduction for a share of the general overhead of the organization or for depreciation.

IX. Tax Information Reporting/Internal Revenue Service (IRS) Administration:

Expand Form 990-T reporting requirement to include more reporting on: (1) activities and income which the organization claims to be exempt or excluded from UBIT, and (2) revenue sources such as contributions, grants, or other funding sources. Provide more detailed reporting of revenue-producing activities and income on Form 990. Consider "short form" reporting for all small organizations, based on revenues.

Require affiliated group that includes an exempt organization to file a consolidated information return.

Recommend that IRS have an integrated examination program for exempt organizations and subsidiaries (taxable and exempt).

Recommend that IRS conduct the following studies and report on:

> (1) nonprofit exempt hospital reorganizations (examining the extent, purpose, effect of the use of subsidiaries); (2) exempt organizations that file Form 990s but do not file Form 990-Ts (examining activities of a sample group to determine compliance with UBIT); (3) the feasibility of requiring State and Federal land-grant universities to file an information return; (4) the use, purpose, and effect of joint ventures; and, (5) study, after five years, on effect of UBIT changes.

X. Miscellaneous:

Codify IRS position (upheld by some courts) that a social club (or other organization whose investment income is subject to (UBIT) may not, in determining UBIT, reduce its net investment income by losses on sales to non-members.

Exempt from UBIT an organization's contingent rental income received through a prime tenant, where the prime tenant leases real estate from a tax-exempt organization, the prime tenant's net profits are based on fixed rents derived from subtenants, and the prime tenant does not provide services to subtenants except through an independent contractor.

Exempt from UBIT investment income earned from non-refundable loan commitment fees. Modify rules applicable to organizations "testing for the public safety."

Consider modification of various piecemeal UBIT exclusions enacted since 1969.

In response to these discussion options, approximately 400 comments were received by the Oversight Subcommittee from the nonprofit sector and the business community. Some of those providing written comments had previously testified before the

Subcommittee in June of 1987.

C. Additional Hearings

The Oversight Subcommittee conducted an additional day of hearings on May 9, 1988, to supplement the written comment process. Testimony was given by representatives of Treasury, the Small Business Administration, the Service, and 16 organizations. O. Donaldson Chapoton, Assistant Secretary (Tax Policy), spoke extensively on behalf of Treasury and addressed each of the discussion options. Mr. Chapoton generally endorsed many of the options, with some reservations, and identified certain potential administrative difficulties.

Robert I. Brauer, Assistant Commissioner (EP/EO), spoke on behalf of the Service and emphasized that during 1987 the Service received approximately 30,500 returns on Form 990-T, Exempt Organization Business Income Tax Return. The tax dollars collected for this year amounted to $119 million, which is double

that collected in 1986, ($53 million) and almost four times that collected in 1985, ($30 million). The Assistant Commissioner also noted that over half the Forms 990-T filed report a loss; that since 1985 the number of returns filed has increased only 15% annually; that one-third of examined returns were not voluntarily filed on a timely basis; and, that for those returns filed voluntarily, revenue agents typically proposed tax increases ranging from 30% to 50% more than the total tax reported by the organization.

Those speaking on behalf of exempt organizations criticized many of the discussion options and urged that Congress not enact legislation that would be harmful to the exempt community. Representatives of the business sector generally supported the discussion options, and some argued that even stricter standards should be adopted.

Chairman Pickle concluded the hearing by stating that the Subcommittee will continue to study the area, and that recommendations will be made reasonably soon to be forwarded to the full Committee. The May 9 hearing received significant coverage in the press, including a front page article in the New York Times the following day. On May 12, the Times editorial page discussed the Congressional review of unrelated business taxable income and cautioned that any legislation should be deferred until the need is clearer. Subsequently, the Washington Post editorial page also addressed this issue and referred to the current statute's "technical intricacy and obscurity."

On June 28 and 29, 1988, the House Small Business Committee held hearings on competition by nonprofit organizations and government entities with small businesses. The Chairman of this Committee, Rep. LaFalce, said that he was attempting to gain an understanding of the problem, and that he hoped the Committee would assist Congress in developing solutions acceptable to both the business community and the nonprofit sector. Rep. LaFalce acknowledged the work of the Oversight Subcommittee with respect to its review of the tax on unrelated business income, and stated that he looks forward to the Subcommittee's policy recommendations.

The Committee heard 17 witnesses, including James C. Miller, Director of the Office of Management and Budget, Frank Swain of the Small Business Administration, Jennie Stathis of the General Accounting Office and Lorry Spitzer of Treasury. Other witnesses included representatives of the nonprofit sector, the business community and the academic world. Rep. LaFalce concluded the hearings by stating that the problem of competition will not be addressed this year but

should be a priority item for the Small Business Committee next year. A working group should be formed and hearings across the country might be needed. The scope of the problem will be defined and a questionnaire will be developed.

D. Follow-up Actions by Congress

On June 23, 1988, Chairman Pickle forwarded to the members of the Oversight Subcommittee a draft report describing recommendations on unrelated business taxable income. This proposed draft report was not approved by the Subcommittee and was not formally released to the public. However, in its Daily Report for June 24, 1988, the Bureau of National Affairs (BNA) published the draft recommendations. See BNA, 6-24-88, L-4 (No. 122).

Although these draft recommendations have not been adopted by the Oversight Subcommittee, they may be indicative of the direction in which changes to unrelated business taxable income are heading. The draft recommendations generally follow the lead of the March 31 discussion options in identifying and addressing various troublesome issues that arise in the context of unrelated business taxable income. Many of the discussion options are expanded upon, while some options are deleted. For example, the draft recommendation on gift shops/bookstores contains specific dollar limits affecting the sale of mementos ($15), reproductions from a collection ($50), and sales to students by an educational organization ($15). Also, the draft recommendations would retain the "regularly carried on" test (which the discussion options proposed to delete), and abolish the "convenience exception" (in accordance with the discussion options). In addition, the draft recommendations contain a complex formula for allocation of expenses where property is used for both exempt and nonexempt purposes.

In view of the fact that these draft recommendations are merely proposals that have not been approved by the members of the Subcommittee, this article will not detail all of the many differences and similarities between the draft recommendations and the discussion options. It is very possible that these proposals will be the subject of additional changes and refinements before being finalized.

From the developments of the past year, it is apparent that Congress has not yet completed its review of the area of unrelated business taxable income. The Oversight Subcommittee, which two years ago was charged with the responsibility of comprehensively reviewing the area, has not yet reported its findings to the Ways and Means Committee. At the time this article was being prepared it seemed

likely that no additional Congressional action would occur this year, and that any possible changes would have to be considered during the next Congressional term. This issue is far from being resolved and, in the opinion of the Chairman of the Small Business Committee, it will be a priority issue next year. Whether any legislative changes will emerge from this Congressional review remains to be seen.

While legislative changes are uncertain, administrative improvements seem likely. In a letter dated October 14, 1988, the Chairmen and ranking minority members of the House Ways and Means Committee and Oversight Subcommittee formally advised the Service to proceed with improving information reporting and data collection relating to the income-producing activities of exempt organizations. The Congressmen asked that the Service institute changes in the Form 990 and the Form 990-T in time for the 1989 tax year. Specifically, they requested that the Forms be revised to include the basis upon which an organization's activities are related or unrelated to the organization's exempt purposes, the amount of income from each activity, and a description of any activity that was not previously reported by the organization. They stated that it was not their intent for the Service to modify the present rules for determining whether an exempt organization must file an annual information return or unrelated business income tax return. The Service was also urged to "better coordinate" the programs for auditing exempt organizations.

E. Legislative Developments

For a discussion of recent legislation affecting unrelated business taxable income (and all other aspects of exempt organizations) enacted as part of the Omnibus Budget Reconciliation Act of 1987 and the Technical and Miscellaneous Revenue Act of 1988, see Topic K, Recent Legislation, beginning at p. 134.

3. Advertising Income

A. American Medical Association v. United States

Last year's CPE Text beginning at p. 82 discussed a case decided by the U.S. District Court for the Northern District of Illinois in American Medical Association v. United States, 668 F.Supp. 1085 (N.D. Ill. 1987) (first opinion). The Court initially arrived at the following conclusions:

> (i) Readership content expenses of periodicals distributed free of charge to nonmember physicians should be treated as fully

deductible direct advertising costs, rather than partially deductible readership costs;

(ii) Dues placed in an association equity fund may be excluded from membership receipts for purposes of the pro rata allocation formula under Reg. 1.512(a)-1(f)(4)(iii);

(iii) Dues collected from members who would have received periodicals free of charge even if they had not been dues-paying members should be included in calculating membership receipts allocable to circulation income under Reg. 1.512(a)-1(f)(4)(iii);

(iv) The cost of other exempt activities under Reg. 1.512(a)-1(f)(4)(iii) includes all costs of other periodicals, not just readership costs;

(v) The one-year subscription rate (rather than one-half the two-year subscription rate) should be used in calculating membership receipts allocable to circulation income under Reg. 1.512(a)-1(f)(4)(iii);

(vi) A portion of reduced dues paid by medical students, interns, and residents may be used in calculating membership receipts under Reg. 1.512(a)-1(f)(4)(i).

Following the initial opinion, the court issued a supplemental opinion in American Medical Association v. United States, 668 F.Supp. 1101 (N.D. Ill. 1987) (second opinion), that addressed the validity of the advertising income regulations under Reg. 1.512(a)-1(f). The court found that Reg. 1.512(a)-1(f) is a reasonable implementation of IRC 512(a)(1) and, therefore, is a valid regulation, except with regard to (f)(4). In this respect, the court stated that since Reg. 1.512(a)-1(f)(4) was substantially modified after it was published as a proposed regulation, it is invalid because it was not properly promulgated, i.e., it was not republished in proposed form. The court noted that most regulations promulgated by the Service are "legislative" rather than "interpretative" and are therefore subject to stricter requirements under the Administrative Procedure Act (APA).

The Government requested reconsideration of the second opinion on the basis that the APA notice requirement is inapplicable to Reg. 1.512(a)-1(f)(4) because it is "interpretative" rather than "legislative." The court rejected the request

for reconsideration in American Medical Association v. United States, 688 F.Supp. 358 (N.D. Ill. 1988) (third opinion), based on a finding that the Government had waived the argument that the regulation was interpretative. The concept of waiver was based on the court's perception that the Government had previously admitted that the regulation was legislative in nature. In fact, a fair reading of the opinion indicates that while the Government had stated that most governmental regulations, including Treasury regulations are subject to the APA, it had not argued that such regulations are legislative rather than interpretative. Nevertheless, the court adhered to its "waiver" notion and buttressed its decision by addressing the substantive nature of the issue presented. Having reviewed all the relevant precedents available, the court concluded that the issue is "... one that has never been decided specifically in any case, and that has been treated with blurred contours in the somewhat related case law." Despite this seeming uncertainty on the substantive issue, the court was still persuaded that the regulation should be subject to the stricter APA notice requirement. Ultimately, however, the court denied the request for reconsideration based on the Government's aforementioned "waiver."

On August 15, 1988, the U.S. District Court for the Norther District of Illinois issued a fourth opinion in American Medical Association v. United States, Civ. No. 82-C-9213 (N.D. Ill. 1988). In this opinion the court criticized the Government for failing to republish and repromulgate Reg. 1.512(a)-1(f)(4). The court adopted the American Medical Association's interpretation of the regulations and held that the organization is entitled to a full refund as claimed.

At this time there have been four separate opinions issued by the court in American Medical Association v. United States. What began as a fairly technical dispute as to a proper interpretation of the advertising regulations under Reg. 1.512(a)-1(f) has been transformed into a case in which a significant provision of the regulations has been invalidated on procedural grounds. These opinions may serve as a vehicle for additional attacks on Service regulations, not only in the area of advertising income, but also with respect to all Treasury regulations. The District Court's judgment has been appealed to the Seventh Circuit Court of Appeals. The appeal addresses both the procedural issue of the invalidation of the regulations, as well as some of the substantive issues considered in the court's first opinion.

B. West Virginia State Medical Association v. Commissioner

Another opinion involving advertising income was recently issued by the Tax Court in West Virginia State Medical Association v. Commissioner, 91 T.C. No. 41 (September 20, 1988). This case concerned a medical association that is exempt under IRC 501(a) as an organization described in IRC 501(c)(6). The organization publishes the West Virginia Medical Journal, a monthly magazine that is distributed to the organization's members. The journal consists of four scientific articles per issue concerning medical topics, as well as general news and reports of governmental actions and social activities. The journal also contains paid advertisements. While most of the advertisements are for health or medical products, other products of interest to physicians are also advertised. From 1974 to 1986 the organization claimed losses from its advertising activity in amounts ranging from $18,874 to $63,786. The organization has not made a profit on its advertising since 1962.

In 1983 the organization received revenue from I.C. Collection Systems, a national organization that collects overdue accounts for doctors. During this year I.C. Collection Systems paid the organization a commission in the amount of $9,908 for endorsing and marketing its collection services. The organization attempted to offset this commission income with a loss of $21,810 attributable to advertising.

In analyzing the situation, the court stated that advertising losses may offset unrelated business taxable income only if the advertising activity is a trade or business. The court cited Cleveland Athletic Club v. United States, 779 F.2d 1160 (6th Cir. 1985), The Brook, Inc. v. Commissioner, 779 F.2d 833 (2d Cir. 1986), and North Ridge Country Club v. Commissioner, 89 T.C. 563 (1987), all of which discuss whether a social club may deduct from investment income losses from food and beverage sales to nonmembers. The court noted that in dicta both Court of Appeals decisions state that the lack of a profit objective with respect to one activity would preclude, under IRC 512(a)(1), the offset of losses from that activity against income from another activity which does have a profit objective. The court concluded by emphasizing the organization's consistent advertising losses over a period of 21 consecutive years, which evidences a lack of a profit objective. Under these circumstances the organization's advertising activities were held not to be a trade or business, and advertising losses may not be used to reduce unrelated business income.

4. Social Clubs

A. Portland Golf Club v. Commissioner

Last year's CPE Text beginning at p. 89 discussed the on-going litigation arising in connection with attempts by social clubs to deduct from investment income losses from food and beverage sales to nonmembers. In accordance with Rev. Rul. 81-69, 1981-1 C.B. 351, where an exempt social club's sales of food and beverages to nonmembers are not profit motivated, the club may not deduct losses from such sales to nonmembers against its net investment income. Litigation on this issue resulted in conflicting Court of Appeals cases in the Second and Sixth Circuits. In Cleveland Athletic Club v. United States, supra, the court held that a social club may net the excess expenses attributable to sales of food and beverages to nonmembers against its investment income. In The Brook Inc. v. Commissioner, supra, the court held that a social club could not use its losses from sales of food to non-members to write off a portion of its gross income from investments. The Sixth Circuit based its holding on the social club's activities having a basic purpose of economic gain, while the Second Circuit was persuaded by the club's stipulation that it had no profit motive when it engaged in the activity of selling meals to nonmembers.

The 1988 CPE Text focused on North Ridge Country Club v. Commissioner, supra, which held that all of an exempt social club's nonmember activities, including golf, golf cart rentals, food and beverage sales, and guest fees, were engaged in with the intention of making a profit. The Tax Court's finding was based on the "incremental increase of available funds" whereby the club profited by each dollar earned above the direct costs of such activity. The Government strongly disagreed with the court's holding in North Ridge Country Club, and, in the spring of 1988, it was announced that the Solicitor General authorized an appeal in this case. A decision from the Ninth Circuit Court of Appeals is expected. This decision, whether favorable or adverse to the Government's position, would create an active conflict in the Circuits and could serve as a vehicle for Supreme Court consideration.

Yet another decision on the issue of social clubs' losses was rendered by the Tax Court in Portland Golf Club v. Commissioner, T.C. Memo 1988-76. Here, a social club exempt under IRC 501(a) as an organization described in IRC 501(c)(7) owned a private golf and country club, with a golf course, restaurant and bar, swimming pool, and tennis courts. Members and guests generally utilized these facilities, and the club derived most of its income from exempt sources. Nonexempt function income was derived from investments and from sales of food and beverages to nonmembers. From 1975 to 1984 the club incurred losses from the sale of food and beverages to nonmembers. The loss resulted from the excess

of direct variable costs (such as food, drinks, payroll) plus an allocable portion of fixed expenses (taxes, insurance, depreciation, administration, etc.) over receipts. The allocation method was not in dispute in this case. Prices on sales to nonmembers were set so as to result in an excess of receipts over direct variable costs of such sales (the excess being characterized by the club as a profit), but not over direct costs plus allocable fixed costs.

The Government argued that the club's losses should not be deductible in determining unrelated business taxable income since the expenses causing the losses were not incurred in a trade or business carried on for profit. Since the club had no expectation of recovering all directly allocable expenses of its nonmember sales, it did not engage in the selling of food and beverages to nonmembers with a profit motive. In the Government's view, absent a profit motive, the club's nonmember sales of food and beverages do not constitute a trade or business and, therefore, the expenses connected with this activity were not deductible under IRC 162. Under these circumstances, it is improper to use the losses from the sale of food and beverages to nonmembers to reduce unrelated business taxable income from interest.

The Tax Court again rejected the Government's arguments and stated that this situation is indistinguishable from that described in North Ridge Country Club v. Commissioner. In the court's view, Portland Golf Club had a profit motive in its nonmember food and beverage sales activity since the excess over direct variable costs helps to carry the fixed overhead. The court believes there is no distinction overhead. The court believes there is no distinction between Portland Golf Club and North Ridge Country Club, and both organizations are entitled to offset unrelated business taxable investment income by losses from nonmember food and beverage sales.

B. Phi Delta Theta Fraternity v. Commissioner

A different kind of social club issue involves the treatment of a fraternity's magazine. In Phi Delta Theta Fraternity v. Commissioner, 90 T.C. No. 68 (May 16, 1988), the Tax Court considered whether a fraternity was subject to unrelated business income tax on net investment income received from an endowment fund used by the fraternity to finance publication of a magazine.

The fraternity, which is exempt under IRC 501(a) as an organization described in IRC 501(c)(7), maintains an endowment fund. Pursuant to the regulations of the fund, the fraternity publishes a magazine, which is printed five

times a year and is distributed to alumni, undergraduates, libraries, and universities. Substantially all of the copies of the magazine are distributed to alumni. The magazine contains articles about successful alumni, announcements of important upcoming events, alumni athletes, a directory of fraternity officers, chapters and members, an obituary section covering deceased alumni, and "The Alumni News."

The endowment fund generated investment income, which the fraternity attempted to exclude from the computation of unrelated business taxable income. The fraternity argued that the net investment income was set aside under IRC 512(a)(3)(B) for a purpose specified in IRC 170(c)(4). Under IRC 512(a)(3)(B) the term "exempt function income" means all income set aside for a purpose specified in IRC 170(c)(4), which includes educational purposes. In the fraternity's view, the magazine is educational because it states in its masthead that it is an educational journal; the magazine is distributed to alumni, students, libraries, and universities; the magazine provides readers with positive role models and informs them of current topics of interest such as alcoholism and drug abuse; and, the magazine encourages the fraternity's members to make charitable contributions to their schools and to participate in school sponsored activities. The Government argued that the magazine is not educational because its main purpose is to disseminate fraternity news to members.

In determining whether the fraternity's magazine is educational, the Tax Court cited Reg. 1.501(c)(3)-1(d)(3)(i), which states that "educational" relates to the instruction or training of the individual for the purpose of improving or developing his or her capabilities; or the instruction of the public on subjects useful to the individual and beneficial to the community. The court reviewed the magazine's editorial policy, which emphasizes providing information on fraternity developments and the achievements of members and alumni. With the exception of occasional articles on drug abuse or alcoholism, the court viewed the contents of the magazine as providing the fraternity's members with a source of news concerning alumni and fraternity events. Although some educational purpose may be served in an incidental manner, the magazine's substantial purpose is to disseminate fraternity news and information for its members. The court concluded that the magazine is not devoted exclusively to educational purposes and, therefore, it is unnecessary to determine whether certain funds were properly set aside under IRC 512(a)(3)(B). Under these circumstances the fraternity's net investment income constitutes unrelated business taxable income.

An additional discussion of social clubs can be found in Topic E, Social Clubs: IRC 501(c)(7) Organizations, beginning at p. 51.

5. Conclusion

During the past few years the area of unrelated business taxable income has assumed a high profile in the world of exempt organizations. Many court cases have been decided on a variety of issues affecting various aspects of a statutory provision whose "technical intricacy and obscurity" has been noted in the editorial page of the Washington Post. In fact, the tax on unrelated business income, though admittedly intricate, is no longer obscure. Congressional scrutiny and press coverage have ensured that familiarity with IRC 511-514 is no longer confined to Service personnel and tax practitioners. It will be interesting to see what changes, if any, occur as a result of the lengthy and thorough review of the area being undertaken by Congress. Even if no statutory changes were to be enacted, the mere existence of Congressional involvement has raised everyone's consciousness with regard to this sensitive and significant provision.